

Strategy of monetary targeting in 1997-8

At its meeting on December 19, 1996, the Central Bank Council of the Deutsche Bundesbank extended the time horizon of its monetary targeting to two years. The decision provided that the money stock M3 is to expand at an annual rate of about 5% in the course of 1997 and 1998. The Central Bank Council additionally set a target corridor of 3½% to 6½% for 1997.

Monetary targeting in 1997-8

The Central Bank Council's decision on monetary targeting in 1997-8 reads as follows:

"The increased volatility of monetary trends emanating, in particular, from the international financial markets has prompted the Deutsche Bundesbank in recent years to emphasise the medium-term nature of its monetary policy to a greater extent than in the past. In its current decision on the monetary policy strategy it also has to take due account of the specific conditions governing German monetary policy in the run-up to stage three of European monetary union. Against this background, it is extending the time horizon of its monetary targeting to two years. In this way it wishes to contain any potential uncertainties about the orientation of its monetary policy during that period. As before, the Bundesbank will review the signals proceeding from monetary developments in the context of a broadly-based analysis of all the facts relevant to trends in monetary stability.

*Decision of the
Central Bank
Council*

The Deutsche Bundesbank will continue to conduct its monetary policy in such a way that price stability is safeguarded and, at the same time, the monetary conditions for lasting economic growth remain in place. To this end, the Bank regards it as being appropriate for the money stock M3 to expand in the course of 1997 and 1998 alike at the rate of about 5% per annum. In order to give the markets a guideline for the pace of monetary expansion that is tolerable in the shorter run, the Bundesbank lays down, in addition, for the year 1997 (from the fourth quarter of 1996 to the fourth quarter of 1997) a target corridor of 3½% to 6½%. The width of the corridor, at 3 percentage points (unchanged from 1996), is intended to take account of the persistently high volatility of shorter-run monetary trends. At the end of 1997 the Bundesbank will define in more detail the range of the envisaged M3 growth rate for 1998.

The Bundesbank is thereby abiding by its strategy of monetary targeting, as well as by the money stock M3 as the key benchmark variable for its monetary policy. Although monetary developments have been subject to pronounced fluctuations in the past few years, the underlying long-term monetary relationships still remain sufficiently stable."

Continuation of monetary targeting

1996 monetary target missed

Monetary growth again found itself in troubled waters last year. The 1995 target was undershot, after which the money stock M3 rose very strongly, particularly in the first

quarter of 1996. Although it subsequently increased at a slower pace and drew closer to the ceiling of the target corridor, the target was still overshot. In November 1996 the money stock M3 exceeded its average level of the fourth quarter of 1995 by 8.0% and was thus above the target corridor of 4% to 7%.

The Bundesbank is abiding by its strategy of monetary targeting in spite of the persistent volatility of shorter-term monetary growth and the fact that the target was again not met. It is a strategy which is characterised by a number of advantages. By announcing a monetary target, the central bank provides economic policy makers, the general public and financial market players with a guideline on the monetary policy stance which is planned. This makes the formation of expectations easier and helps to "anchor" expectations concerning price movements at the level envisaged by the central bank. Published monetary targets imply a self-imposed commitment on the part of the central bank. They have a disciplining effect since the central bank is compelled to justify any deviations from the target path. Finally, monetary targeting makes it possible to clearly define areas of responsibility. The central bank is responsible for the medium-term course of inflation, but not for fiscal policy or wage rate policy decisions which affect inflation in the short run.

Advantages of monetary targeting

Monetary targeting continues to be based on empirical evidence. In order to be able to control the money stock by means of interest rate changes and hence ultimately influence

Monetary targeting based on empirical evidence

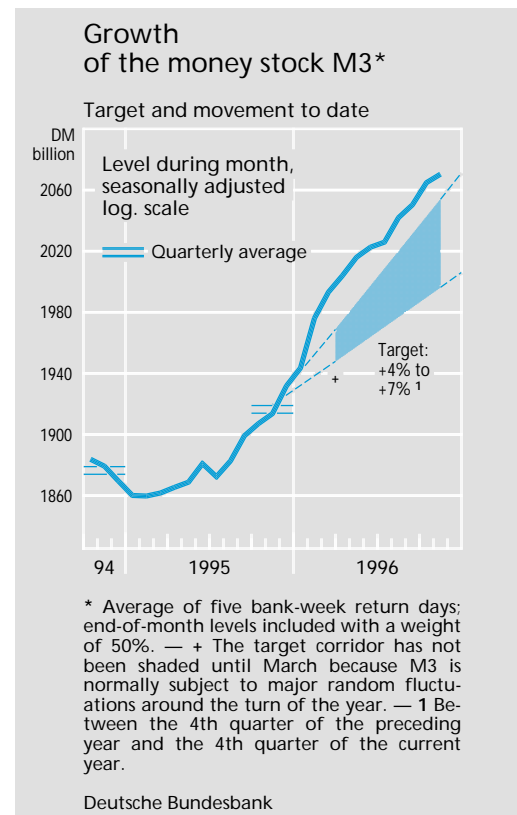
price movements as planned, there should be a clearly defined relationship between the demand for money and a small number of key macroeconomic variables – such as the gross domestic product and interest rates. In the medium-term-oriented monetary targeting approach, which focuses on the longer-term relationship between the money stock and prices, what is of primary importance is the stability of the long-term money demand. The majority of econometric studies show that the demand for money is sufficiently stable in Germany. For that reason, monetary growth continues to be a suitable anchor for the Bundesbank's policy of maintaining price stability.

Policy consultants support monetary targeting approach

The strategy of monetary targeting still meets with broad support in Germany. Policy consultants largely agree on the fact that the conditions required for retaining monetary targeting continue to exist unchanged. In its most recent Report, the Council of Experts pointed out that the missing of last year's monetary target did not cause the Bundesbank any problems of credibility regarding its resolute anti-inflationary stance. Like the economic institutes, it advised the continuation of the monetary targeting approach.

Retaining M3 as a benchmark variable

The Bundesbank is also retaining the money stock M3 as its benchmark variable. M3 continues to show better results in empirical studies than other monetary aggregates. Nevertheless, the volatility of the money stock M3 has increased in recent years. The effects emanating from the international financial markets, in particular, have led to increased fluctuations in monetary growth.



Furthermore, the demarcation lines between money and monetary capital are more blurred now than used to be the case. Therefore, the statistically recorded money stock at times also includes funds which will not affect expenditure in future and, for that reason, will not be relevant to inflation either. This means that there is a greater need to interpret and explain monetary growth. At the same time, the money stock M3 has a reduced capacity to be an accurate leading economic indicator. These difficulties are likely to persist in the near future, too.

Against that backdrop, the Bundesbank has basically retained its monetary targeting strategy during the past few years, but has, at the same time, taken greater account of the overall monetary policy setting in its analysis

Monetary policy setting and medium-term monetary trends

along with the money stock. Admittedly, M3 still leads the hierarchy of indicators. But the signals emanating from monetary growth are examined as part of a broadly-based analysis of all the facts relevant to trends in price stability. Moreover, when interpreting monetary growth and stating the reasons for its interest rate decisions, the Bundesbank has placed greater emphasis on medium-term monetary relationships.

Two-year targeting

Change in underlying conditions due to European monetary union

Two-year targeting with a formal corridor of 3½% to 6½% for 1997 therefore does not represent a fundamental change in strategy. The Bundesbank is thereby taking account, in particular, of the changed underlying conditions for German monetary policy in the run-up to stage three of European monetary union. Uncertainties in the financial and foreign exchange markets might increase, above all, in the so-called interim period, which will begin in spring 1998 with the decision on those countries which are to participate in stage three of EMU and will end with the start of monetary union on January 1, 1999. Since the individual currencies will draw progressively closer to complete interchangeability, the necessity of closer monetary policy coordination between participating central banks might increase as well.

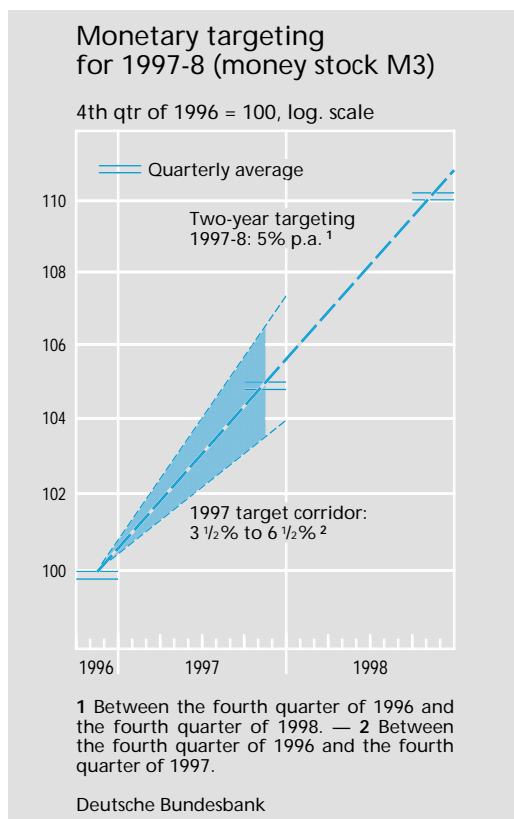
Under these circumstances, two-year targeting sets a clear signal for the markets. It illustrates the fact that the Bundesbank will abide both by its anti-inflationary stance and its strategy until the agreed start of monetary

union at the beginning of 1999. Setting a clear-cut monetary policy target is intended to reduce uncertainties in the financial markets and to create confidence in the continuation of stability policy. Furthermore, the two-year target could serve as a kind of reference variable for any monetary policy coordination that is necessary.

Above and beyond that, the Bundesbank's approach is guided by the intention of helping to give the future European Central Bank as smooth a start as possible. The most important "heirlooms" in this respect are favourable price prospects and as high a degree of monetary policy credibility as possible. Both of these require a strict anti-inflation policy in the run-up to monetary union. The announcement of a two-year monetary target lays the foundation for this.

Finally, the current expansion of the time horizon in response to the present situation creates the conditions that will allow the ECB to carry on smoothly from the Bundesbank's policy of monetary targeting. The decision on the appropriate monetary policy strategy in the monetary union will ultimately be at the sole discretion of the ECB Governing Council. From the Bundesbank's point of view, however, monetary targeting – whatever precise form it takes – should be part of the ECB's strategy. The ECB will initially have to act subject to great uncertainties with regard to monetary relationships and the transmission process in the European currency area and will, moreover, gain credibility only gradually. It is likely that it will not be able to cope in such a situation unless there is a convincing

Start and strategy of the ECB



“pre-commitment” in terms of anti-inflation policy. A pragmatic monetary targeting approach which is geared towards the special features of this currency area would therefore appear to be important in order to master the (in any case) difficult starting phase in terms of strategy, too.

Derivation of the monetary target

*Overall
benchmark
figures*

In line with its potential-oriented approach, the Bundesbank, as before, derived the 1997-8 monetary target from overall benchmark figures for the growth of real production potential, the medium-term price assumption and the trend in the velocity of circulation of money.

An annual growth rate of just over 2% was envisaged for all-German production potential on an average of the years 1997 and 1998. This is slightly higher than the increase last year, which was revised downwards (from 2½% originally to just under 2%) owing to the sluggish pace of investment activity. In both 1997 and 1998, production potential in the new Länder will rise more sharply than in the old Länder; according to available estimates, the east German share in this period will amount to around ½ percentage point. Compared with 1996, potential growth in eastern Germany will slow down, however, whereas it will increase slightly in western Germany. The trend in western Germany will be chiefly influenced by the fact that private investment activity is likely to recover to a certain extent during 1997 and that a somewhat greater increase in the capital stock is to be expected in association with this in 1997-8. Furthermore, the potential total number of man-hours worked will probably rise again for the first time in four years owing to a slight increase in the number of employed persons and a smaller reduction in working hours under collective wage agreements than in the preceding years.

*Production
potential*

As the second benchmark figure, the two-year target has been based on a medium-term price assumption of 1½% to 2%. The Bundesbank is thus responding to the continued progress in price stabilisation and the ongoing favourable outlook for prices. In 1996, all comprehensive price indices were distinctly below the 2% mark. The all-German GDP deflator, which is the basis for converting real production potential into

*Medium-term
price assumption*

nominal potential, rose by no more than 1.0%; the increase in the consumer price index was only slightly higher.

A year earlier the Bundesbank had attached the lowering of the medium-term price target to the condition that the rates of price rises would be able to settle down durably at below 2%. For a number of reasons, such a scenario seems to be quite realistic for the next two years and hence for the likely "remaining maturity" of the Deutsche Mark. The provision of the economy with liquidity influencing expenditure does not reveal any inflationary risks at present (see page 23 f.). Moreover, more than in the past, the globalisation of the goods markets and the tighter competition accompanying it are now narrowing the scope for raising the prices of internationally traded goods worldwide. This is augmented by the increased stability awareness of the monetary authorities and the pressure on them generated by globalised and inflation-sensitive financial markets. Furthermore, given high unemployment, pay settlements which continue to be moderate and thus a favourable trend in unit labour costs are to be expected in Germany. Finally, administrative price increases are likely to become less significant. The historically low capital market rates also indicate that the prospects of inflation being contained in the long term are assessed as favourable at present for a large number of countries – including Germany.

Against that background, the setting of the new price target indicates more explicitly than hitherto that the Bundesbank's deter-

mination to fight inflation does not stop at the 2% inflation mark, which has always been defined as the upper limit. The Bundesbank will continue to play an undiminished part in safeguarding price stability in the two-year run-up to monetary union. In this respect, too, it will do its utmost to enable the ECB to have as smooth a start as possible.

An addition of 1 percentage point was again made for the trend decline in the velocity of circulation of money, measured by the ratio of nominal production potential and the money stock M3. This figure, which has been used since 1993, has been retained owing to an updating of the trend calculations. As in past years, it is based on a long estimation period; this is consistent with the proposition widely reaffirmed by empirical studies that the stability of the demand for money is ensured in the long run.

"Velocity of circulation"

The sum of the stated benchmark variables yields an expansion of the money stock M3 of around 5% per annum on the average of the years 1997 and 1998. Taking into account the current monetary situation, the Bundesbank has translated this reference value into a multi-quarter growth rate that is consistent with production potential from the fourth quarter of 1996 to the fourth quarter of 1998.

Results

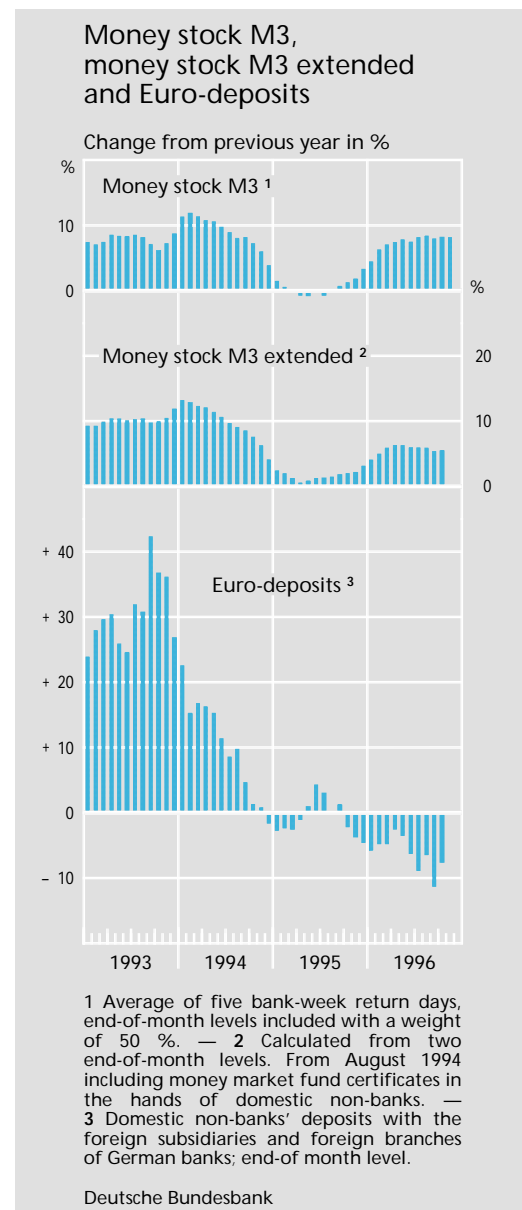
At the end of 1996 the monetary starting point was marked by an overshooting of the four-quarter target and rapid monetary growth on an annual average. In November the money stock M3 was 8.0% higher than in the fourth quarter of 1995; the average

Monetary starting point

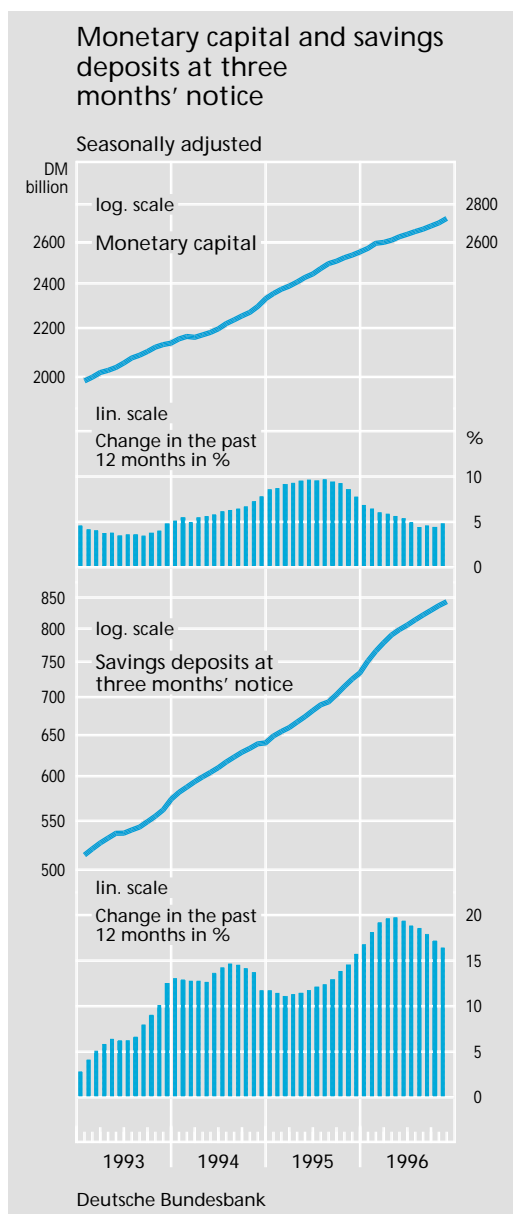
annual growth rate could thus have been around 7½%, thus being 2 percentage points higher than the figure on which the derivation of last year's monetary target was based. This raised the question of whether this overshooting of the monetary target should be reflected by a deduction when setting the new monetary target. The Bundesbank refrained from doing so because it does not perceive any inflationary risks on the monetary side. This perception is borne out by a number of indices. For instance, the money supply in the medium term does not seem to be unduly high or low; over the past three years, the money stock M3 grew by an average of 5½% and was thus more or less in line with the potential.

*Overstating
the growth
rate of M3*

In addition, last year's M3 growth rate is likely to overstate the liquidity expansion in the economy which influences expenditure. The strong monetary growth in 1996 was attributable, in particular, to the "asset acquisition behaviour" of domestic non-banks. It was largely fuelled by a steep increase in special savings facilities. To that extent, the statistically recorded rise in the money stock M3 probably includes a significant amount of funds which ought rather to be included in monetary capital and which should therefore not influence demand in future. This assessment is supported by the growth of the aggregate M3 extended. In 1996, this more broadly-defined monetary aggregate (which, in addition to M3, includes non-banks' money market fund certificates and their monetary balances in the Euro-market) rose distinctly less rapidly than M3. This was mainly attributable to the sharp reduction in



Euro-deposits during the course of the year. Since these funds were, on balance, converted mostly into domestic money components, a certain bloating of the German money stock – but not of overall liquidity in the economy – was recorded. This puts the fact that M3 overshoot its target into perspective and suggests assigning a greater weight to M3 extended when assessing the liquidity situation than in the two preceding years,



when these monetary aggregates diverged less strongly than they do now.

Four-quarter growth of about 5% for 1997 and 1998 alike

Owing to the analysis of the liquidity situation described above and the estimated status of the money stock M3 at the end of 1996, the Bundesbank translated the annual average target value into a four-quarter growth rate in keeping with the potential of about 5% per annum for 1997 and 1998. This single-

figure target, which signals a slower growth of M3 than last year, illustrates the Bundesbank's determination to combat inflation.

In the shorter run, however, such a single-figure target does not settle the question of the range within which the Bundesbank feels monetary growth to be tolerable. In order to provide better guidance to expectations in this respect, the Bundesbank supplemented the two-year target of 5% by a target cone of between 3½% and 6½% for 1997. The fairly symmetrical corridor has been slightly lowered in comparison with 1996. This also demonstrates that, following the overshooting of the 1996 target, the Bundesbank is endeavouring to keep monetary growth on the potential-oriented path this year. From the present perspective, the prospects of this seem to be quite good, since the sharp growth of the money stock M3 last year was mainly attributable to "outliers" in February and March 1996, when monetary capital formation was very poor under the impact of the volatile financial markets. In the further course of the year, the increase slowed down perceptibly; in the last six months between June and November the money stock M3 rose at an annual rate of 5½% and thus more or less in line with production potential.

Formal target corridor of between 3½% and 6½% for 1997

Width of the target corridor unchanged

For 1997 the Bundesbank retained last year's widening of the target corridor to 3 percentage points. This seemed advisable, especially in view of the higher volatility of shorter-term monetary growth. Seen in this light, it also seems appropriate to make certain provisions

for such fluctuations by means of a larger "safety zone".

*Continuity
preserved*

On balance, the 1997 monetary target is largely in line with previous practice and thus preserves a large measure of continuity in the policy of monetary targeting. With a view to the approaching start of stage three of EMU, the traditional procedure was simultaneously embedded in a necessary two-year targeting.

Together with the setting of the target corridor for 1997, the Bundesbank announced that it will define the range of M3 growth envisaged for 1998 in more detail at the end of 1997. However, the four-quarter growth of 5% establishes the basic orientation. This clearly signifies that the Bundesbank will stay on the path of stability during the "remaining maturity" of the Deutsche Mark.